Sam Walsh is about to sell his house and move to Arizona to retire. He bought the house eight years ago when the real estate market was in a slump. The market is booming now, and some of his friends have recommended that he sell his home without a real estate agent. Sam has seen books that describe how to advertise a house, how to conduct a successful open house, and how to negotiate with a potential buyer through the process of offer and acceptance, purchase and sale, and closing. And of course the Internet now offers new possibilities for listing one's home. Given all these resources and a booming market, Sam thinks perhaps he could sell his house fairly quickly and for a good price by himself, without paying an agent’s 6 percent commission.

But Sam isn’t so sure that the savings are worth all that effort and anxiety. Granted, real estate agents are expensive, but what if selling independently doesn’t go well? And it seems like an awful hassle. Wouldn’t it be easier to let an agent handle all the details? And more comfortable not to have to do all that negotiating with the buyer?

Sam calls a family friend who recently bought property in the neigh-
borhood and asks her whether she liked her real estate agent. "Sure," the friend says. "She's a great agent—her name is Betty Ortiz. Give her a call. She’ll help you out."

THE GOAL: REAPING THE FULL BENEFITS OF HIRING AN AGENT

Sam wonders whether hiring a real estate agent will provide a net benefit in the sale of his home. On the one hand, maybe an agent will sell his home more quickly and for more money than he could otherwise get. If he doesn't use an agent, maybe his home will sit unsold for months. But on the other hand, maybe the agent won't earn her commission and will end up costing Sam money. How should Sam decide what to do? How will his decision about hiring an agent affect the sale of his home? Moreover, if he hires an agent, how should he negotiate the terms of that relationship?

Agency relationships are everywhere. We constantly delegate authority to others so that they may act in our place. We ask lawyers to represent us; we give money managers authority to make our investments; we ask doctors to take responsibility for our medical care; we depend on employees to do the work we assign; and we elect public officials to legislate on our behalf. Indeed, it is hard to imagine how society could function at all without agents acting on behalf of principals—diplomats on behalf of nations; labor leaders on behalf of unions; sports agents on behalf of players; literary agents on behalf of authors.

When a principal hires an agent to act on his behalf in negotiations across the table with another party, he may expect—naively—that the agent will be motivated solely to serve the principal's interests. This is how principal-agent relations would work ideally. But in the real world, agents always have interests of their own. As a result, the principal-agent relationship is rife with potential conflicts that demand skillful management behind the table.

For example, a client and his lawyer may need to negotiate how the lawyer will be paid; how the other side will be approached; what information will be sought from or disclosed to the other side; at what point to accept the other side's offer, and so on. If these issues are left unacknowledged and unaddressed, they can adversely affect the negotiation
across the table. For all of these reasons, effective negotiation requires a good understanding of the benefits and risks of the agency relationship and how it can best be managed.

Agency Benefits

Why are agency relationships so pervasive in negotiation? Because an agent can provide significant benefits to her principal. These benefits derive from four sources:

- **Knowledge:** An agent may have specialized knowledge—that the principal lacks—about market conditions, formal or informal norms, or relevant risks and opportunities. An investment banker will know potential buyers for her client's company, for example, and may be better able to price the deal.

- **Resources:** An agent, by reason of his reputation and relationships, may be able to provide access and opportunities that would otherwise be unavailable. For example, a well-known literary agent can get a publisher to read a new author's manuscript, and later negotiate favorable deal terms, because of the agent's reputation for having good judgment.

- **Skills:** An agent may be a better negotiator than the principal, whether owing to experience, training, or natural ability. A client may hire an attorney to negotiate a settlement or a deal, for example, because the client believes that the lawyer will be more effective.

- **Strategic advantages:** An agent may be able to use negotiation tactics on behalf of the principal in a way that insulates the principal from their full impact. The principal can remain the "good cop" while the agent plays the bad cop. For example, a sports agent can engage in hard-bargaining tactics with the team's general manager while the player remains on good terms with the team. Conversely, a collaborative agent may be able to settle a dispute with an agent on the other side even if the principals are in conflict.

In many cases, the agent will be able to do things the principal could never do on his own, and the possibility for both the principal and agent to benefit from trade between them is clear. The agent may have an absolute advantage over the principal with respect to those activities. In Sam and Betty's case, Betty may have skills, knowledge, and resources that Sam lacks. But economic theory suggests that even if Sam knows
as much—or more—about selling residential real estate as Betty, that doesn’t necessarily mean that he should sell his house himself. The economic principle of *comparative advantage* dictates that there can be gains from trade when each party (whether a person, firm, or country) specializes in the production of goods and services for which that party’s opportunity cost is lower. If Sam’s opportunity costs are high, it may be more efficient for Sam to hire Betty as his agent and spend his time doing what he does best.

Imagine that Sam has decided to talk to Betty about whether to hire her. They meet at his home on a Saturday afternoon. Betty walks through the house, noting approvingly many of the details and features that might raise the selling price. As Sam gives Betty a tour, she asks him all sorts of questions—about the square footage of the house, when he purchased it and what he paid for it, the age of the appliances and heating system, the condition of the roof, any electrical work or other upgrading he might have done. By the time they sit down to talk, Betty has a fair picture of the investment that Sam has made.

**Betty:** Well, it’s a beautiful property. You obviously care a great deal about your home. The kitchen is lovely—you made a wise choice to remodel there. I think you should do very well, given the way houses are selling this season. The first thing we would need to do is agree on a listing price and a date to put the house on the market. I’d suggest sooner rather than later. As for a price, I’ve brought some information we can look at.

**Sam:** That’s great. But before we get into the numbers, I wondered if we could talk about your services. To be honest, I’m still trying to decide whether to retain an agent at all, rather than sell the house myself.

**Betty:** Oh, sure. No problem. I would definitely go with an agent, but then I’m biased. But let me tell you the sorts of advantages having an agent brings.

In describing the role she will play for Sam in the transaction, Betty emphasizes the sorts of benefits described above. First, Betty says she can help Sam get the best possible price for his house. “Setting the right asking price is critical,” Betty says. “I know the market.” She’s brought lots of information showing recent sales in his neighborhood and town, recent trends in the market, and detailed comparables that she would use...
to justify whatever price they arrive at. “It’s not easy setting just the right price,” Betty says. “Too low and it’s easy to sell but you don’t get full value. Too high and you can scare off potential buyers. Or if you do find one, the bank won’t finance their mortgage.”

Betty then describes her approach to marketing and shows Sam a few sample brochures of other houses she has sold recently. She also emphasizes how her relationships might benefit Sam. “I have some clients of my own who might be interested, and I know every important broker in town,” she explains. She tells Sam that after putting his house on the market she would first bring a caravan of other real estate brokers through in order to expose the house to those working in the area. Then she would invite brokers to bring their own clients for a few days before hosting the first open house on a Sunday afternoon. “That’s a big draw,” Betty says. Brokers who have seen the house already will try to get their clients back before the open house. And then the open house should attract lots of casual lookers and those clients who weren’t able to make it during the week. After the initial open house, Betty explains, she would hold open houses for two more weekends. “I can also save you from what would otherwise be a real nuisance. I’ll be responsible for showing your house, and I’ll be sure that we set these open houses and other visits at times that are convenient for you.”

**SAM:** That would be great. The less hassle, the better.

**BETTY:** Last but not least, I’ve had lots of experience at negotiating home sales. Not only can I help you get the best price, I can help you figure out which offers to take seriously, how best to make counteroffers, and what secondary terms are reasonable. In my experience it’s best if the seller doesn’t have to deal directly with the buyer or the buyer’s agent. You’ll find it a lot more comfortable to hold out for the good price if you don’t have to deal directly with the other side.

**SAM:** What about after I’ve accepted an offer?

**BETTY:** Well, I’ll take care of moving toward a formal purchase and sale agreement. I’ll make sure any necessary inspections get done, and sometimes I even help the buyers get their mortgage.

Betty and Sam keep talking, and Sam sees the advantages that Betty will confer in terms of skills, resources, and knowledge. She has access to clients and other brokers, she knows the market, and she has lots of time
to invest in selling his house. He decides that he'll use an agent, and he feels comfortable with using Betty. She seems open and easy to talk to, and not too pushy.

**SAM:** OK, but what about fees? What would your commission be on a sale?

**BETTY:** My commission is the standard 6 percent of the sale price. You pay nothing unless we sell the house. Actually, the fee is normally split with the buyer's agent, assuming there is one. But whether or not the buyer has an agent, the fee is 6 points.

**SAM:** Hmm. What happens if you sell the house very quickly? Is the fee still 6 percent?

**BETTY:** Yep, if we sell it quickly, isn't that a good thing? That's what we want, right?

**SAM:** Sure, I guess. But the quicker the sale, the less work you have to do, right? And what if there isn't a buyer's agent? What if a random buyer just walks in to the first open house and plucks down my asking price? Is the fee still 6 percent?

**BETTY:** Yes, it is.

**THE PROBLEM: AGENCY COSTS**

Sam sees the advantages of hiring Betty. But there's a nagging question in his mind: Are these fees really worth it? What if she sells the house without much effort? Or what if she doesn't work hard enough? How will Sam know? Despite Betty's upbeat attitude and optimism about working together to sell his house, Sam fears there may be problems down the road. At this point, however, he's not sure exactly what those might be.

Hiring an agent is not a simple matter. Bringing an agent into a negotiation introduces a third tension: between the principal and the agent. Because agents often have expert knowledge, substantial experience, and special resources that the principal lacks, the relationship can create value. At the same time, however, because the agent's interests may not align with those of the principal, a number of unique and intensely stubborn problems can arise. The literature on this subject is vast, largely because these problems are so pervasive and cut across so many activities. Here, we introduce some of the central issues.
The Sources of the Tension

Agency costs are not limited to the amount of money that a principal pays an agent as compensation for doing the job. They also include the money and time the principal spends trying to ensure that the agent does not exploit him but instead serves his interests well. To understand why agency costs exist, consider that principals and agents may differ in three general ways:

- Preferences
- Incentives
- Information

DIFFERENT PREFERENCES

First, the preferences, or interests, of an agent are rarely identical to those of the principal. Consider their economic interests. Betty’s primary economic interest is in her own earnings as a real estate agent. In this transaction, Sam’s primary economic interest is in the net sale price for his house. Betty may have other interests as well. She has a strong interest in her reputation and in securing future clients. She has an interest in maintaining good relationships with other agents, banks, home inspectors, and insurance agencies. Betty is a repeat player in this game, while Sam, particularly if he intends to leave the community, is a one-shot player who might be more than willing to sacrifice Betty’s reputation in order to get a better deal for himself. Conversely, Betty may be reluctant to bargain hard for certain advantages for Sam because of her desire to maintain a congenial relationship with the buyer’s agent, who may be a source of future client referrals.

DIFFERENT INCENTIVES

Agency problems may also arise because the incentives of the principal and the agent are imperfectly aligned. The culprit is typically the agent’s fee structure, which may create perverse incentives for the agent to act contrary to the principal’s interests. This discrepancy is sometimes called an incentive gap.

For example, Sam wants an arrangement that maximizes his expected net sale proceeds after her fee. Betty, on the other hand, wants a fee
structure that yields her the highest expected return for her time spent. If they agree to a percentage fee, Betty may prefer a quick and easy sale at a lower price to a difficult sale at a higher price because with the former she will get more return for hours spent working. Indeed, a recent study suggests that when realtors put their own homes on the market, they tend to get higher-than-average prices, because they get the entire benefit of their additional hours of work, not just 6 percent of it.

**DIFFERENT INFORMATION**

The information available to the principal and the agent may differ. We are speaking here of kinds of information that either side may have an incentive to keep to itself. Betty may know that market conditions are improving, for example, but she may be reluctant to share this with Sam for fear of inflating his expectations. Similarly, it may be difficult to know how much effort an agent is actually putting in on the principal’s behalf. Because the principal cannot readily discover this information, the agent might shirk her responsibilities and earn pay without expending effort.

**Management Mechanisms and Their Limitations**

These potential conflicts can be controlled somewhat, through three basic management mechanisms:

- Incentive contracts
- Monitoring systems
- Bonding

**INCENTIVE CONTRACTS**

Incentives can be built into contracts between principals and agents to better align their interests. For example, instead of paying employees an hourly wage, a manufacturing firm might choose to pay its workers by the piece, thereby tying compensation of these agents directly to volume. Or a distributor might pay its salespeople on a commission basis, compensating them only to the extent that their sales efforts boost the bottom line. Similarly, farm workers are often paid by the amount of produce harvested instead of by the hour, to minimize slacking, and waiters are paid through tips, to encourage more attentive service.
Many different incentive structures exist, including:

- Percentage compensation
- Hourly fees
- Fixed fees
- Bonuses or penalties

These methods can minimize the principal-agent tension, but no incentive structure can ever completely resolve it. To see why, consider our real estate example. Real estate agents are commonly paid a commission only if a sale is completed. This is an incentive contract: the agent’s reward depends on successful performance. Such contracts have both benefits and drawbacks. On the one hand, Betty profits—and Sam incurs agency-related costs—only if Betty manages to sell his house. On the other hand, as we have seen, this incentive may induce Betty to pressure Sam to accept a deal that is not optimal for Sam but which guarantees Betty a quick profit in comparison to her efforts. To be perfectly aligned, Betty’s incentives vis-à-vis the sale would have to be identical to Sam’s. But for this to occur, Betty would have to buy the house herself and resell it; only then would she have a 100 percent stake in the sale, as Sam does. This, of course, would transform her into the principal stakeholder and eliminate the agency relationship altogether.

Because Betty does not have as great a stake in the sale as Sam does, Betty and Sam may face conflicting incentives at various points in the transaction. Suppose that with very little effort, maybe 25 hours of work, Betty could sell Sam’s house for $250,000. With a 6 percent commission, this would generate a $15,000 fee—$600 an hour. Assume that with a great deal of effort, perhaps 100 hours of work, the house could be sold for $275,000. Sam would pay Betty an additional fee of $1,500 on the extra $25,000. From Betty’s perspective, the marginal effort may not be worthwhile. She works 75 extra hours for only $1,500—which works out to $20 an hour. Even if Betty could sell the house for $300,000 with only 50 extra hours of work, she might still decide that it was not worth the extra $3,000 fee at $60 per hour. She might feel that her 50 hours would be better spent selling someone else’s house at a much higher hourly rate—even though Sam would almost surely feel that an extra $47,000 in his pocket justified the additional time on Betty’s part.
Uncertainty about the housing market will further complicate Sam and Betty's task. Neither of them knows what will happen if Sam turns down an offer of $250,000 and Betty puts in additional effort in the hope of receiving $275,000 or $300,000. Most likely, however, Betty will have more information on this point than Sam. Can he trust her to reveal this information candidly, when it might be in her interest for him to accept the lower offer?

Consider the homeowner's dilemma at an even earlier stage of the transaction, before the house goes on the market. After thinking about these problems, Sam might realize that Betty has an incentive to set a low selling price for his home so that it could be sold quickly and with little effort. Reaching for the stars isn't in Betty's interest. It might not be in Sam's interest either, but he wants to be sure that Betty is giving him information candidly. He might thus decide to ask a number of agents for competing estimate recommendations. Although this could provide him with some reassurance, competition of this sort is not a complete solution. Instead, such competition may encourage agents to make unrealistically high estimates in the hopes of securing an exclusive listing. After the listing is secured, an agent might put the house on the market for the high price but then expend little effort trying to market the house. After some period of time, the agent might then approach the owner and indicate the necessity of lowering the price to increase the chances of a sale. In the end, the homeowner may end up worse off for having initially set an unrealistically high price, particularly if a record of large unilateral price concessions is taken by prospective buyers to indicate that the house is of questionable value. Again, information disparities make it difficult for the principal to align the agent's incentives with his own. The homeowner may be unable to monitor the agent's efforts or the accuracy of a single agent's estimates.

Why doesn't Sam just pay Betty by the hour? Many professionals—including lawyers and accountants—have traditionally been compensated in this way. At first glance, this may seem a straightforward way to guarantee that the agent expends the needed effort to get a good price. In reality, however, compensation by the hour creates an incentive for an agent to put in more time than may be necessary to get a good price. To earn a large commission on the sale of Sam's house, Betty will necessarily have to invest a great deal of time. A quick sale with little effort
The Tension between Principals and Agents

will be less profitable for her than a sale that takes longer. Other things being equal, of course, Sam would prefer a sale sooner rather than later. Betty's incentive to put in extra time doesn't necessarily meet Sam's needs.

An hourly fee also creates monitoring problems. How does Sam know the number of hours Betty is actually putting in? And how does he know whether those hours are being spent efficiently, in a way that most benefits Sam? Is she diligently pursuing buyers, contacting other agents, and creating attractive brochures and ads to market the property? Or is she just holding open houses over and over again so that she can bill Sam for the set-up and break-down time? Sam might have reason to fear that Betty will not use her time most productively under an hourly fee arrangement.

Sam could also offer to pay Betty a fixed fee for her work. Assume that Sam expects to list the house for $250,000. He and Betty know that if the house sells for this amount she'll earn a commission of $15,000. But neither knows what the actual sale price will be. The market is hot. Maybe Sam will receive offers above his asking price—it's been known to happen in his neighborhood. Or maybe no buyer will come along and he'll have to drop the price to $230,000, or even lower. If Sam believes that the hot market will work to his advantage, he might offer to pay Betty $15,000, regardless of the sale price. He would thus insure against the possibility of a greater fee, at the risk that he would overcompensate Betty in the event the market failed him and the price had to be lowered.

Fixed fees have certain advantages. They encourage the agent to get the job done within the cost parameters set by the fixed fee. However, fixed fees can create perverse incentives of their own. If Betty will receive $15,000 regardless of her effort or the sale price, why should she put in the time required to sell the house at $250,000, as long as she sells it at some price?

What about a percentage fee with a clause to reduce the percentage if the house sells very quickly? Sam has already expressed concern that the house might sell in just a few days with minimal effort on Betty's part. If that's the case, why should Betty get her full 6 percent commission? Sam might propose that if the house sells within seven days of listing, Betty's commission will be reduced to 4 percent. Even if Betty agrees to this fee structure, however, it creates a new set of incentive problems. Now Betty
has an incentive to delay. Why sell the house on day five if on day eight she’ll make an additional 2 percent?

What about some hybrid of a percentage fee and an hourly fee? After all, Sam’s real concern is that Betty will slack off if the house doesn’t sell quickly. It’s on day fifty that he needs Betty to work at selling the house, not on days one and two. Thus, Sam might suggest a lower percentage fee—perhaps 5 percent—plus an hourly bonus for work performed after day fourteen. In this way, he might hope to inspire Betty to put effort in when he needs it most. But from Betty’s perspective, this arrangement forces her to put effort into trying to sell a house that’s not priced right for the market. Why should she bear the burden in such a situation? Why shouldn’t Sam lower the price and thus generate more sales interest? And why should she work toward an early sale—which Sam, too, would prefer—if it just means that she’ll get a lower percentage fee?

MONITORING SYSTEMS

If incentive contracts don’t completely solve the problem, why can’t a principal just watch over his agent and ensure that the agent performs satisfactorily? This is the second management mechanism: monitoring. If Sam knows which marketing activities are most likely to result in the sale of his house, he can simply follow Betty around and see whether she engages in those activities. This mechanism is often used by employers, who monitor their employees and compensate them based, in part, on how well they perform.

The problem with monitoring, however, is that it is expensive and it doesn’t always tell the principal what he needs to know. In order to determine whether an agent has performed appropriately, the principal must be able both to observe the agent’s behavior, which is often impossible, and to distinguish desirable from undesirable behavior, which is often beyond the principal’s expertise. Sam, for example, can’t watch Betty’s every move. To do so would waste the time he is saving by hiring her in the first place. In addition, even if he did watch her closely, he might not be able to distinguish between high-quality and low-quality work. If only three people attend his first open house, should he blame Betty? Were her marketing efforts substandard compared to what other agents would have done? Sam is unlikely to know.

Perhaps Sam could employ another specialist or expert to monitor
Betty. This approach is not uncommon. For example, a corporation’s in-house lawyers often monitor the efforts of the corporation’s outside lawyers, who work for private firms. Similarly, outside corporate directors often monitor the efforts of management. It should be obvious, however, that this is hardly an ideal solution. Hiring yet another professional to provide services is expensive—and the compensation arrangement for this other professional may *in itself* create distorting incentives. Moreover, a conspiracy of sorts may develop between the agents. In the corporate world, management is often responsible for selecting their monitors—the outside or “independent” directors. This inevitably raises concerns about informal collusion. In a general sense, such collusion results from the fact that similarly situated agents have more frequent contact with each other than principals and agents do. To the extent that agents expect to have repeat dealings with one another, this may well affect their behavior—sometimes in ways that may benefit the principal, but other times in ways that do not.

**BONDING**

Principal-agent differences can also be dampened by requiring the agent to post a bond, usually in the form of money, at the start of the agency relationship, which he must forfeit if he acts in a way that conflicts with the principal’s interests. In the construction industry, a contractor may post a bond underwritten by an insurance company that can be used to complete the job for the owner if the contractor goes broke during the project. Pensions are sometimes considered such a bond: throughout their careers employees are induced to act in their employers’ best interests for fear of losing their pension’s large financial rewards. Similarly, compensation that is above market rates can be considered a form of principal-agent bond: if an employee is found acting contrary to the employer’s interests and is fired, he forfeits the market surplus that he has enjoyed up to that point.

An agent’s concern for her reputation can also serve as a bond to protect her principal. Even if Betty has an economic incentive not to spend extra time working for a sale price above $250,000, and even if she knows that Sam cannot effectively monitor her shirking, Betty might still work diligently in order to keep her professional reputation intact. Real estate agents often acquire clients through word of mouth. Without
recommendations from previous clients like Sam, Betty is unlikely to succeed in her business.

While in some circumstances the principal may be able to affect the agent's reputation, this is generally an imperfect solution to agency problems. It may be difficult to observe or verify that a particular outcome—success or failure—is attributable to the agent's actions.

In addition, principals can exploit agents as well as the other way around. For example, a homeowner might use an agent to acquire valuable information about the home's expected value, and even to begin testing the house on the market, but then exclude some friend or acquaintance from the agency contract and subsequently sell the house directly to this third party. By doing so, the buyer and seller could share in the savings of the agent's fee, while the agent would be left uncompensated for her efforts.

For our purposes, one major lesson emerges: although these management mechanisms can reduce principal-agent differences, none of them eliminates the tension completely, alone or in combination. Our third tension is inescapable: there are always agency costs. In a particular context, some mechanisms will obviously be better than others. But reputational markets are never perfect. Monitoring is always costly. And any compensation scheme creates incentives that can be perverse in some circumstances. In a relatively simple transaction such as a real estate sale, the parties may not find it worthwhile to expend resources writing elaborate agency contracts. To do so would just further shrink the pie. In addition, trying to exert control over an agent can have paradoxically negative consequences on the agency relationship: in part, agents are value-creating for their principals because they are independent decision-makers, not puppets.

Principal-Agent Problems in the Legal Context

The principal-agent relationship of most interest to us here is the relationship between a lawyer and a client who are involved in a legal negotiation. Like all other agency relationships, this one poses problems for both parties, owing to differences in preferences, information, and incentives. Here, we briefly outline some management mechanisms that
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can dampen the principal-agent tension when it arises in the context of a legal negotiation.

INCENTIVES

To tackle incentive problems, lawyers and clients have developed an array of fee structures—all inevitably flawed. The most common of these are:

• Contingency fee
• Hourly fee
• Fixed fee
• Mixed fee
• Salary

Contingency Fee: In this arrangement, the lawyer earns a percentage of the recovery, if any, that he wins for the client. This structure is most often used by plaintiffs’ attorneys in tort litigation, and it has the same advantages and disadvantages as the percentage fee in our real estate example. Its chief advantage is that the plaintiff pays nothing unless there is a recovery. A contingent fee also enables a plaintiff to engage in a lawsuit that she otherwise might not be able to afford. In essence, the client is selling the lawyer a third of her lawsuit in exchange for the lawyer’s services. It is a reasonably effective way of aligning the parties’ interests, in that the lawyer has an incentive to win a large recovery for the client. The incentives are not perfectly aligned, however, because the lawyer is putting in all the effort and only receiving a fraction of the benefit. The contingent-fee lawyer may be better off with a quick settlement that takes little effort rather than a higher recovery that requires substantially more work. A contingency fee can also allow a client to exploit her attorney. Plaintiffs’ lawyers typically screen their cases carefully because they are bearing part of the risk of failure.

Hourly Fee: Under this arrangement, the lawyer is paid by the hour. This fee structure is most often used by defense counsel in litigation and by deal-making attorneys. Its advantage is that it motivates the lawyer to devote the time needed to achieve the best result for the client—particularly when it is not clear from the outset how much time the matter will
consume. The disadvantage for the client is that it removes any necessary link between the benefit the lawyer's work confers on the client and the amount the client pays. The lawyer may be tempted to do more work in order to earn more, even if the work is unnecessary. On the other hand, hourly billing may disadvantage the lawyer in some circumstances. For example, lawyers may be reluctant to charge on the basis of normal hourly fees when the lawyer's special expertise and experience can produce very substantial economic benefits for a client in a short period of time.

**Fixed Fee:** Here, the lawyer earns a specified amount for handling a particular legal matter. This arrangement gives the lawyer an incentive to get the work done in as short a time as possible, and it caps costs for the client. On the other hand, the client may have an incentive to try to expand the scope of the work covered by the fixed fee.

**Mixed Fee:** Hybrid fee arrangements are becoming increasingly common. For example, a client may pay her lawyer a diminished hourly rate plus a bonus if the lawyer achieves good results. Although a hybrid of this sort may align incentives reasonably well, it is often difficult to implement. A precise formula for computing the bonus may be hard to establish in advance, especially where there is no single, easily measurable benchmark for a good outcome. The parties may simply agree to negotiate the amount of the bonus after the fact, but at that point lawyer and client may have different notions of what more, if any, the lawyer deserves.

**Salary:** A salaried lawyer works for a single client, whether a government agency or a private corporation. Bringing counsel in-house does not eliminate the principal-agent tension, however. The lawyer still has interests of her own. The incentive effects will depend on the details of the salary arrangement and career paths within the organization. Compensation may share the characteristics of either a fixed fee arrangement or even hourly fees, depending on how the lawyer's pay is computed. In-house counsel are sometimes thought to be more risk-adverse and less willing to provide independent legal advice that the client may not want to hear, because their career depends on keeping the favor of a single client.
MONITORING SYSTEMS

The principal-agent tension may be dampened by monitoring the agent's activities. This is difficult and expensive in the legal context, with respect to both inputs and outputs. To know whether a lawyer is acting solely in his client's interest, the client must possess enough knowledge to evaluate the lawyer's decisions and must be able to observe the lawyer's behavior. There may be no easy way for a client to verify information about a lawyer's true work habits, diligence, or timekeeping practices. Similarly, it may be quite expensive for a client to monitor the quality of her lawyer's work, unless the client is herself an attorney. Often in-house corporate counsel can monitor the activities of outside counsel, but this is hardly a cost-free solution.

REPUTATIONAL BONDING

To the extent that potential clients have access to accurate information about an attorney's reputation, the attorney will have more incentive to build and maintain a reputation for trustworthiness and hard work. If an unsatisfied client can go elsewhere in the market for legal services, a lawyer is more likely to act loyally and diligently to keep that client. But this constraint is an imperfect one. Once a lawyer-client relationship has been established, it is often very costly for the client to leave one lawyer and start a new relationship with another. In the middle of a lawsuit or a complicated transaction, for example, a new lawyer would have to invest a great deal of time to learn what the old lawyer already knows about the matter. Because the client will typically have to pay to educate his new lawyer, these extra costs of switching lawyers midstream mean the market cannot completely constrain opportunism. For this market constraint to operate most effectively, moreover, clients must be able to evaluate the performance of their lawyers, which, as noted above, is no simple matter.

To the extent that a lawyer and client expect their relationship to extend over time, each is less likely to act opportunistically in the present. If the shadow of the future is long, the risk of losing future business may deter present disloyalty. In the corporate world today, however, steady long-term relationships with outside counsel are becoming the exception, not the rule. Rather than long-term retainers, clients increasingly
hire lawyers for a single transaction or for a particular lawsuit. In such short-term one-shot relationships, each side may be more tempted to try to exploit the other.

PROFESSIONAL NORMS
Law is a regulated profession. Explicit and formal professional norms—some aspirational and some that carry the force of law—influence lawyers' actions, as do more informal and implicit norms of behavior that exist within communities of attorneys. Lawyers swear oaths upon admittance to the bar, and they are bound by their state’s rules of professional conduct. We believe that most lawyers take their ethical obligations seriously and want to see themselves as loyal agents. This constraint, however, is obviously less than perfect. The profession’s norms afford great leeway for lawyers who wish to abuse the rules.

Tort law provides an additional constraint on lawyers’ behavior. In general, an attorney is liable for negligence in the handling of a client’s negotiations if she fails to exercise the ordinary skill and knowledge expected of attorneys who work in her field. This requires communicating offers and counteroffers to one’s client, advising one’s client on well-established legal principles that may affect the client’s decision to settle, and explaining to one’s client how a settlement might affect future rights and obligations. Although there are relatively few reported negotiation-related malpractice cases, in some but not all jurisdictions a lawyer may be liable if he mistakenly recommends settlement on the basis of an erroneous assessment of the settlement’s value, or if the lawyer showed poor professional judgment by engaging in questionable negotiation tactics that ultimately led to a less-than-favorable result for his client. All of these constraints can help dampen principal-agent tensions in the legal context. None is perfect, however. Ultimately, as we discuss in Part III, a lawyer and client must negotiate with each other to ensure that both parties are well-served by their relationship. For now, we merely point out that our third tension is highly relevant to the legal context.

THE APPROACH: MANAGING THE TENSION
The central challenge in agency relationships is to capture the benefits while minimizing agency costs. Our approach requires that the tension
be acknowledged and managed explicitly; that principals and agents use the concept of comparative advantage to structure their roles and responsibilities; and that they aim to form a partnership based on reciprocal candor and respect. In Chapter 7 we discuss in some detail how this can best be done in the lawyer-client context. Here, we outline our general advice.

CREATE A COLLABORATIVE RELATIONSHIP THAT MINIMIZES AGENCY COSTS

The principal-agent tension should be acknowledged, not avoided, and treated as a shared problem. Fees and monitoring should be addressed explicitly, not left lurking under the table. Discuss these issues. Rather than have the principal worry silently about the agent’s choices and behavior, principals and agents should search together for ways to reassure the principal without overly burdening the agent. In our experience, openness and candor build trust.

The goal should be to find fee arrangements and monitoring mechanisms that are thoughtfully tailored to a given context. One size does not fit all. If a principal wants an agent exhaustively to research an issue where a lot is at stake, compensation by the hour may create a better incentive than a fixed fee. On the other hand, if a principal is worried about controlling costs and thinks she is in a position to monitor quality effectively, a fixed fee may be better. Consider the incentive effects of different fee arrangements and the feasibility of monitoring either the agent’s inputs (such as time) or the volume and quality of outputs. Similarly, to what extent can reputation constrain opportunism? Perfection may not be possible, but some agency relationships are better than others.

CONSIDER COMPARATIVE ADVANTAGE AND STRATEGY IN ALLOCATING ROLES

A principal and agent may allocate negotiation roles in a variety of ways. At one extreme, the principal may do all the negotiating herself, using the agent as a coach and consultant behind the scenes. At the other extreme, the agent alone may be at the bargaining table and may not even disclose the principal’s identity to the other side. There are many options in between. In some negotiations, the principals and agents are all at the
table together. In others, the principals may negotiate broad deal points, leaving the agents to negotiate the detailed documents that implement the deal.

Sometimes conventions influence who is at the table and how roles are allocated. In residential real estate transactions, offers are generally presented to the seller's agent, who then transmits them to the seller. Buyer and seller may have very little direct contact until the closing. Similarly, sports agents often deal with team representatives without their clients at the table. In litigation, clients typically act through their lawyers, and professional standards prohibit a lawyer from contacting an adverse party, for example, unless counsel is also present.

Principals and agents obviously should take such conventions into account, but they also must consider comparative advantage and may even want to challenge assumptions about who should be at the table. Once again, one size hardly fits all. The preferences, skills, knowledge, and resources of the principal and agent must be considered. What is the agent particularly good at? What about the principal? Who has more information that will be relevant to the upcoming negotiation? Who is more skilled at negotiating? Who has more time or desire to engage in the various tasks needed to prepare for the negotiation? By thinking carefully about their relationship and about what each can bring to the table, a principal and agent can structure their roles so that each does those things for which he is particularly suited.

Strategic implications must also be taken into account. Who your side sends to the table can depend on, and influence, who the other side sends. If your side brings a lawyer, the other side is more likely to bring one, too. Indeed, hiring an agent can often be a strategic signal. If an agent has a reputation for being a warrior, the message is very different than if an agent is known to be a collaborative deal-maker. Your side may wish to discuss with the other side who should be at the table and how the negotiation will be structured. Will principals attend the first meeting? Without such explicit discussion, an agent may show up alone when the other side expected principals to attend and participate. Or one side may bring a whole team of agents and advisors and unintentionally overwhelm the other side.

If an agent plays a role at the bargaining table, what is the scope of the agent's authority or mandate, and what information is the agent autho-
rized to share with the other side? If a principal is fearful that his agent will disclose too much, this worry can inhibit the principal from sharing necessary information with his agent. On the other hand, by sending only the agent to the bargaining table, a principal may be able to avoid having to answer awkward questions that might be posed by the other side.

The most salient question is whether the agent has the authority within a particular range to settle a dispute or make a deal. This is an important issue for principals and agents to discuss in allocating roles. Too often, however, an agent will simply ask the principal for her bottom line or reservation value to make clear just how far the agent can go. This can be a mistake for several reasons.

First, as Roger Fisher and Wayne Davis have pointed out, whenever there are multiple issues in a negotiation, "there is no one 'bottom line.' The minimum figure acceptable on one issue, such as price, will depend on what is proposed on other issues, such as credit, interest rate, closing dates, warranties, and restrictions." By oversimplifying the principal's interests, an agent may leave himself with much less room to search for trades that create value, and he may reinforce the notion that negotiation is purely distributive.

Second, if an agent merely asks for his principal's bottom line, the principal has an incentive to manipulate the agent by exaggerating the reservation value in order to encourage the agent to work harder. The principal may fear disclosing her true reservation value, expecting that the agent may treat as a goal what the principal sees as a minimally sufficient point of indifference. Or, the principal may simply exaggerate to set high aspirations for the agent.

Finally, in some circumstances, the principal cannot—if unassisted—evaluate her best alternative. In a legal dispute, for example, the best alternative to a negotiated settlement will typically be to pursue litigation. But without a lawyer's help, most clients cannot make reasonably informed judgments as to whether a proposed settlement is reasonable in light of the opportunities and risks of litigation.

Rather than ask for the principal's bottom line, the more appropriate, and subtle, question is how the agent's authority should be adjusted during the course of a negotiation. Paradoxically, limiting the authority of agents may facilitate brainstorming and the development of creative
solutions because neither agent has power to bind. At the outset of a negotiation, it may be best for the agent to have no authority to make a binding commitment on substantive issues but instead to have a broad mandate to design a negotiation process, discuss interests, and generate options.14

CONSIDER THE INCENTIVES CREATED BY AGENCY RELATIONSHIPS ON THE OTHER SIDE
In addition to thinking through principal-agent issues on your side, you should consider the relationships on the other side as well. Do not naively assume that the other side is a "unified actor" with a single set of interests. What are the agent's incentives? A broker or a sales agent may get paid only if the deal goes through. A contingent-fee lawyer who is very pressed for time because of other commitments may be eager to settle. An executive on the other side may either support or oppose a merger, depending on how his career will be affected. In crafting proposals, it is not enough to consider only the interests of the principal on the other side. The agent's incentives and interests should be taken into account as well.

BEWARE OF THE TACTICAL USE OF AGENTS
The agency relationship can be used to implement a variety of hard-bargaining tactics. An agent can play the bad cop to his client's good cop, or vice versa. Ambiguities about authority can be exploited to take two bites at the apple: an agent at the table might extract a final concession from you in order to strike a deal, only to report subsequently that his principal demands more—he really had no authority to commit. A problem-solving negotiator must be able to recognize these tactics and deploy effective countermeasures. Naming their game and being explicit about process and authority can help, as we suggest in Chapter 8.

CONCLUSION
Agents are used pervasively in negotiations, and the principal-agent tension—like the other two—must be managed. Use of agents complicates bargaining by creating a web of relationships in which a variety of actors interact, each with his own interests, incentives, and information. The
introduction of agents—and the system of relationships it generates—may be either a blessing or a burden with respect to the management of the first two tensions.

Consider the tension between empathy and assertiveness. An agent may compensate for his principal’s more limited repertoire of communication and interpersonal skills. For example, an agent may help his principal better understand the perspective, interests, and needs of the other side. At the table, an agent may be better able than his principal to demonstrate understanding of the other side and to assert effectively. In circumstances where the principals have difficulty communicating with one another, a pair of agents can construct a bridge between them.

But none of this automatically follows from the introduction of agents. Communications between the two sides may become more twisted, not less, as additional players enter a negotiation. If the principals receive all of their information about what’s going on across the table through their agents, a manipulative agent can seriously distort his principal’s perceptions and decision-making. Rather than helping his principal demonstrate understanding of the other side, an agent can inflame conflict and demonize. Rather than serve as a bridge, a damaged relationship between the two agents can itself become a barrier.

The same is true of the tension between creating and distributing value. As a counselor, an agent can help a principal better understand and prioritize his interests. An agent’s knowledge, skill, and contacts may help the principal in assessing and improving his BATNA. And an agent may be able to broaden the set of options under consideration. At the table, the agent may be more able constructively to lead the way. Agents help create a negotiation process that manages the distributive aspects of negotiation without inhibiting value creation. Even in the face of hard-bargaining tactics, a skilled agent may be able to change the game to problem-solving.

But bargaining through agents can destroy value if their involvement leads to escalating transaction costs and distributive stalemate. An agent may be a specialist in hard-bargaining tactics—a mercenary for hire. A real danger is that agents will merely increase costs, delay negotiations, and exacerbate tensions.